



CITY OF DURHAM | NORTH CAROLINA

DATE: January 18, 2011

TO: Thomas J. Bonfield, City Manager

THROUGH: Wanda S. Page, Deputy City Manager

FROM: David Boyd, Finance Director
Keith Herrmann, Deputy Finance Director

SUBJECT: Interest Rate Formula Recommendation for Special Assessments, Capital Facility Fees, and Water and Sewer Construction Petitions

EXECUTIVE SUMMARY

The City Charter allows property owners to pay over time for certain improvements and fees charged under procedures that include special assessments, capital facility fees, and water and sewer construction petitions. The City's current practice is to charge an interest rate of nine percent on all outstanding balances for these items. While a fixed interest rate is simple to administer, the rate may not be reflective of current market conditions. A best practice is to establish fair rates and to change them periodically. A methodology that will keep interest rates in line with economic conditions is to tie the rates to a widely publicized interest rate such as the Prime Rate. City staff have analyzed the current interest rate environment and determined that a formula using the Prime Rate (currently 3.25%) plus an additional mark-up (4.25%) resulting in an interest rate of 7.5% would be appropriate. On an annual basis, the interest rate will be reset at the start of each fiscal year based on the formula and adjusted depending on movement in the Prime Rate. This action would establish the Prime Rate plus additional mark-up as the interest rate formula applicable to assessments, capital facility fees, and water/sewer construction petitions and will require Council to approve one resolution for special assessments; two ordinances for capital facility fees; one ordinance for construction for water and sewer service; and, one resolution that will delegate petition writing power to provide water and sewer service to the City Manager.

RECOMMENDATION

The Finance Department recommends that City Council adopt the: "Resolution stating City Council's intention to base special assessment interest rates on the Prime Rate"; "Ordinance to revise City Code Section 70-50(b)(4) in order to allow interest rates of less than 9% on installment payments for capital facilities fees"; "Ordinance directing the City Manager to annually reset interest rates, in accordance with the Prime Rate, on installment payments for capital facilities fees for water and sewer connections"; "Ordinance directing the City Manager to reset interest rates yearly, in accordance with the Prime Rate, on installment payments for construction for water and sewer service"; and, "Resolution to expand the delegation of authority to the City Manager with respect to petitions to provide water and sewer service."

BACKGROUND

In 1982, Council set the interest rate for assessments at nine percent. City Charter Section 77, Paragraph 22 provides that the interest rate on assessments can be set as high as nine percent if this assessment is paid in installments. The decision to set the rate at the maximum level permissible was in a motion adopted by the City Council under the subject of "Street Paving Assessments and Assessment Interest Rates" on August 2, 1982.

Assessment rolls are confirmed on a periodic basis. The issue about the level of interest rates, however, has not been revisited since being set during 1982, and the rate has remained at the maximum level for the entire time. During 1982 interest rates were high and the nine percent rate was in line with then-current economic conditions.

The interest rate on installment payments of capital facilities fees has been 9% at least as far back as 1992 and perhaps for years before that date. The interest rate on installment payments for construction for water and sewer service has been 9% since 1992.

Staff analyzed the current interest rate environment and determined that it is fair to set the interest rate at the Prime Rate (that is currently 3.25%) plus an additional mark-up of 4.25%. The formula currently results in an interest rate of 7.5%.

Included below are some of the factors that contributed to the staff recommendation of a Prime Rate based formula and mark-up percentage and a description of the analysis performed to determine an appropriate rate.

Prime Rate: The Prime Rate, as reported by the Wall Street Journal's bank survey, is among the most widely used benchmarks to set home equity lines of credit and credit card rates. It is in turn based on the federal funds rate that is set by the Federal Reserve. The Prime Rate is the underlying index for most credit cards, home equity loans, and lines of credit, auto loans, and personal loans. Many small business loans are also indexed to the Prime Rate. All types of American lending institutions (traditional banks, credit unions, etc.) use the Prime Rate as an index or foundation rate for pricing various short-term loan products. The current Prime Rate is 3.25%. The last rate change – a decrease of 75 basis points (.75 percentage points) occurred on December 16, 2008.

Mark-Up: Providers of consumer and commercial loan products often use the Prime Rate as their base lending rate and then add a margin or mark-up to arrive at a fair rate. Staff analyzed several scenarios to determine a fair interest rate, and the analysis formed the basis for determining the mark-up as follows:

Investment Rate (rate of 1%): The City could charge an interest rate that is commensurate with the rate that the City currently earns on its investments. This would represent interest foregone due to the fact that money is being loaned to citizens that would otherwise be available for the City to invest. The current yield on the City's in-house portfolio is approximately one percent and the City could set the interest rate at one percent. The City's investments, however, are essentially risk-free investments (i.e., the City's portfolio has very low risk because it is either invested in the NC Capital Management Trust or backed by guarantees of the federal government). This alternative was rejected because it does not consider the riskiness of the loans.

Borrowing Rate (rate of 3%): The City could charge an interest rate that is commensurate with the rate that the City would be charged were it to issue debt to finance the loans. This would represent how much it would cost the City if it were to issue bonds to finance money loaned to citizens. During the two most recent debt issuances in August and October 2010, the City sold bonds at a rate of approximately three percent, and the City could set the interest rate at three percent. This alternative was rejected because it is unrealistic to assume that the City would issue debt to finance the relatively small amount of these loans. Moreover, the City is a triple-A rated credit, and this alternative does not consider the riskiness of the loans.

Benchmarks (range of rates: 6%, 7%, or 8%): Staff performed a benchmarking survey to determine what other North Carolina cities are charging for the interest rate. The survey results are that Raleigh and Greensboro currently charge six percent interest, and that Charlotte and Cary currently charge eight percent. The City could choose to benchmark its peers and charge the lower rate of six percent, the higher rate of eight percent, or an average rate of seven percent. This alternative was rejected because the survey also revealed that these other cities are not actively revisiting the interest rates and some had been set more than 10 years ago; staff prefers an active approach that reflects current economic conditions.

Market Rates (range of rates between 4.74% and 10.79%): Staff researched what interest rates are currently being offered by local banks to determine what rates citizens would be charged were they to seek alternative financing options with other lenders. These market rates are from the website Bankrate.com, and assume a home equity loan, for borrowers with a good credit rating, secured by a lien on the property, and at a fixed rate. The results are listed in the table below:

Bank	Interest Rate
Wachovia	10.79%
Bank of America	7.69%
SunTrust	6.74%
BB&T	4.74%
Average:	7.5%

Note: the Wachovia rate of 10.79% is above the City's cap of 9%.

The City could choose to set the interest rate at a rate commensurate with any of the rates currently being offered by the banks listed in this table. Because there is a wide range of rates on this table, instead the City could set the interest rate commensurate with the average of market rates listed in the table, or 7.5%. This rate represents the average of prevailing interest rates that are available to citizens in Durham to finance similar types of loans and was determined to be the best indicator of what the City should currently be charging. Moreover, by using an interest rate based on a formula approach, as market borrowing rates increase and decrease along with the prime rate, the rate being charged by the City will remain comparable. Using the current Prime Rate of 3.25%, it is necessary to add 4.25% to arrive at the current average borrowing rate.

ISSUES/ANALYSIS

The intent of this item is to change the interest rate charged by the City on time payments for the items mentioned above (special assessments, capital facility fees, and petitions). For assessments, the means by which the interest rate is actually set is by resolution confirming

an assessment roll, and the action requested in this agenda item is to direct staff to prepare such resolutions with the interest rate calculated as the Prime Rate + 4.25%. Therefore, the resolution that is a part of this agenda item with respect to assessments would not limit the authority of City Council to set interest rates on time payments for improvements made under the special assessments procedures; however the resolution will provide for the application of a consistent market sensitive rate absent any other specific direction from City Council. For example, the City Council may set the interest rate in any resolution confirming an assessment roll at a rate different from the proposed interest rate subject to a maximum of nine percent.

With respect to capital facilities fees and petitions for water and sewer construction, however, the resolutions and ordinances that are part of this agenda item direct the administration to implement new interest rates each year without returning to the City Council. In other words, if the recommended resolutions and ordinances are adopted, the interest rates for these two kinds of payments will be changed without the necessity of further City Council action.

The Prime Rate published in The Wall Street Journal on the fourth Friday of May of each year will be used to establish the interest rate to be applied to all items financed over time during the coming fiscal year. The Prime Rate is the rate at which banks will lend money to their most-favored customers and will move up or down in lock step with changes by the Federal Reserve Board.

To implement these recommendations, changes need to be made to the forms that owners sign in order to set up installment payments for water and sewer construction costs. Resolution 8424 requires the text of those forms to be approved by the City Council. Requiring City Council approval of such forms is an exception to the general rule, codified in City Code section 1-11(b), which authorizes the City Manager to prepare forms. Resolution 8424 would be repealed by the "Resolution to expand the delegation of authority to the City Manager with respect to petitions to provide water and sewer service." With the repeal of Resolution 8424, the City Manager will be able to use the authority in City Code section 1-11(b) to prepare the needed forms. (For reference purposes, Resolution 8424, approved January 20, 1998, is included as an attachment to this memo.)

ALTERNATIVES

Maintain Status Quo: The City Charter specifies that any rate can be used subject to the maximum of nine percent. Therefore, Council could choose to let the rate remain at the maximum level of nine percent.

The overall goal of this resolution is to set the rate annually and to base the rate on a readily available and widely disseminated financial metric (i.e., the Prime Rate). Recognizing, as discussed in the Background section of the memo, that there are a many methodologies that could be used to set the interest rate, staff believes that the formula based approach recommended in this item is preferable to maintaining the status quo.

FINANCIAL IMPACT

Historically, the City of Durham has offered an option to finance special assessments for public improvements (e.g., water lateral, water main, sewer lateral, sewer main, curb, gutter and paving, and sidewalk), capital facility fees, and water/sewer petitions. Regardless of term or current market conditions, the City charges an interest rate of nine percent per annum. There is a desire to craft a solution to charge an "economically sensitive" interest rate. Given the current interest rates, staff have developed a new financing structure that

incorporates a new method to set rates on an annual basis. The new rates will be set at the Prime Rate (currently at 3.25%) plus an additional 4.25 percentage points up to a cap of nine percent.

After thorough investigation of this process, staff recommends that the optional financing plan is feasible whereby individuals seeking financing would be able to finance the project cost or fee over the designated period at a rate equal to the prime interest rate each fiscal year plus the additional 4.25 percentage points up to a cap of nine percent. Over the past eight years, the average amount of confirmations per year (including assessments, facility fees, and water/sewer petitions) has been \$368,989.50. Using the most conservative assumption that 100% will be financed at the new rate of 7.5% (versus the old rate of 9%), the maximum annual financial exposure for the City as the result of the change is estimated to be \$5,534.84.

Staff recommends approval of a 7.5% rate for these kinds of time payments, and that rate would be effective for special assessments, petitions, and applications approved after the recommended ordinances and resolutions are adopted. Beginning July 1, 2011, the prime rate as of the fourth Friday of May, plus 4.25%, would be implemented as described above.

SDBE SUMMARY

The City's SDBE Ordinance is not applicable to this item.

Attachments:

Resolution stating City Council's intention to base special assessment interest rates on the Prime Rate

Ordinance to revise City Code Section 70-50(b)(4) in order to allow interest rates of less than 9% on installment payments for capital facilities fees

Ordinance directing the City Manager to annually reset interest rates, in accordance with the Prime Rate, on installment payments for capital facilities fees for water and sewer connections

Ordinance directing the City Manager to reset interest rates yearly, in accordance with the Prime Rate, on installment payments for construction for water and sewer service

Resolution to expand the delegation of authority to the City Manager with respect to petitions to provide water and sewer service

Resolution 8424, adopted January 20, 1998